Sharyland/Oncor PUCT Proceeding Involves Significant Policy Issues

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The proposed acquisition of Oncor Electric Delivery Company LLC, the state's largest transmission service provider raises important utility regulation policy questions. As widely reported, Shary Holdings LLC and affiliated companies are proposing to acquire Oncor, from the bankrupt Energy Future Holdings through the use of a real estate investment trust (commonly called REITs) that would acquire the transmission assets of Oncor, and retain Sharyland Utilities LP (the regulated affiliate of Shary Holdings) to manage the assets.

The court presiding over the bankruptcy of Energy Future Holdings has already approved the proposed acquisition as a component of the plan to resolve the EFH bankruptcy proceedings, and now the focus has shifted to the Public Utility Commission of Texas Docket 45188 in which Sharyland is seeking approval to acquire control of

Oncor.

While every proposed acquisition of a regulated utility deserves careful review, the unique structure proposed for the Sharyland acquisition of Oncor raises several larger issues about the regulatory philosophy that the PUCT should follow.

Real estate investment trusts receive special treatment under the Internal Revenue Code. Although they are subject to taxation as corporations, they are allowed to deduct from taxable income the dividends that they pay to their shareholders, so long as their income is derived substantially from passive investment in real estate related activities. In the previous decade, Sharyland received from the Internal Revenue Service a private letter ruling that concluded that owning transmission related assets would qualify as a real estate related activity, opening a door to REIT investment in the electric industry that otherwise has remained firmly closed despite ongoing efforts by renewable project developers to gain access to the lower cost capital available through REIT and MLP vehicles.

At a minimum, it should be the policy of the PUCT to favor a capital structure that lowers the aggregate amount of federal income taxes paid by utilities and their investors. As Judge Learned Hand observed, "There is not even a patriotic duty to increase one's taxes." The proper division of the tax savings between investors and ratepayers is a subject for debate, but adopting a policy that discourages tax saving capital structures would disserve Texas ratepayers and utility investors.

Since at least 1962, Congress has required that tax incentives for capital formation (the investment tax credit, accelerated depreciation schedules, etc.) be treated for utility rate making purposes in a way that benefits the investors in utilities rather than flowing the tax savings through to ratepayers. To do otherwise would frustrate the purpose of the tax incentives, which is to encourage capital formation. This requirement not only applies to federal agencies such as FERC, but to state utility ratemaking as well. Congress has not explicitly extended this requirement to the REIT dividend paid deduction for the simple reason that no utility until now has attempted to use a REIT to finance regulated utility property.

To hold that the federal income tax expense for rate making should take into account the dividends paid deduction (thus providing the tax benefit to the ratepayers rather than the REIT investors) would deprive the REIT and its investors of the capital formation incentive that Congress intended accrue to the investors as an incentive for real estate investment. This would ignore clearly stated Congressional tax policy that has been consistently followed since at least 1962.

Depriving the REIT of the benefits of the dividends paid deduction would also undermine the PUCT policy adopted in connection with the CREZ proceedings to foster competition among potential transmission service providers based upon their requested return on capital. If transmission service providers who develop innovative ways to lower the cost of capital are deprived of the benefits of those innovations, transmission service providers will not incorporate those innovations into their proposals to finance new transmission lines. On the other hand, if the allowed rate to Sharyland results in outsized returns, the PUCT can address the issue in future rate cases, and outsized returns will quickly attract competitors bidding on new projects, which will ultimately benefit ratepayers, and result in returns in line with the market price for capital. The only party deprived of benefit if the PUCT adopts this approach will be the federal treasury.

A fundamental tenet of the ERCOT free market approach is that while unsuccessful financing innovations are the investors' risk and burden (witness the EFH bankruptcy), successful innovations are the reward that accrue to investors in exchange for the risk of trying new approaches. Writ large, a decision to award the tax savings attributable to the REIT structure to ratepayers would sound like "heads we win, tails you lose."

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